DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0063
ADJUSTED GROSS INCOME TAX
For the Tax Periods Ending in 1996, 1997, and 1998

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ISSUES

I. Disallowance of Royalty and Interest Expenses – Adjusted Gross Income Tax.

Authority: IC 6-3-1-3.5(b); IC 6-3-2-2(l); IC 6-8.1-5-1(b); Gregory v. Helvering 293 U.S. 465 (1935); Lee v. Commissioner of Internal Revenue, 155 F.2d 584 (2d Cir. 1998); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 3.1-1-8.

Taxpayer maintains that the audit, in calculating its Indiana adjusted gross income, erroneously disallowed certain royalty and interest expenses paid to a related holding company.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the Department should exercise its discretion and abate the ten-percent negligence penalty assessed at the time of the audit. Taxpayer argues that the tax deficiencies were not attributable to its negligence.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of selling industrial, medical, and specialty gases. Taxpayer does business in Indiana and various other states. In 1996, taxpayer's parent company formed a Delaware holding company. Taxpayer, along with other members of the federal affiliated group, then transferred its trade names and related goodwill (Hereinafter "intellectual property") to the holding company in an I.R.C. § 351 tax-free exchange in return for 100 percent of the holding company's stock. At the same time, the holding company and taxpayer – along with the other members of the affiliated group – entered into a licensing agreement permitting taxpayer continued use of the intellectual property. According to taxpayer, the fair market value of the intellectual property at the time of the transaction was determined by an independent third-party. After the holding company received the royalty payments, the holding company loaned the payments back to the taxpayer and the other members of the affiliated group. The holding company charged taxpayer and the other members of the affiliated group interest for the loans at the market rate. The taxpayer's Indiana taxable income was reduced by the consequent deduction of the royalty and interest expenses.

The audit disallowed the royalty and interest expense deductions on the ground that the transactions lacked economic substance and that allowing the taxpayer to deduct the expenses did not fairly reflect the taxpayer's Indiana income. Taxpayer protested that determination, an administrative hearing was held, and this Letter of Findings followed.

DISCUSSION

I. Disallowance of Royalty and Interest Expenses – Adjusted Gross Income Tax.

IC 6-3-1-3.5(b) provides the starting point for determining taxpayer's taxable income stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code . . . ." The Department's Administrative Rules repeats the basic principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code – section 63) . . . ." However, the taxpayer's federal "adjusted gross income" is merely the starting point; IC 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point, the details of which are not relevant here.

The audit disallowed taxpayer's royalty and expense deductions under IC 6-3-2-2(l) which states as follows:

> If the allocation and apportionment provisions of this article do not fairly reflect the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> > (1) separate accounting;
> >
> > (2) the exclusion of any one (1) or more of the factors;
> >
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> >
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Taxpayer argues that IC 6-3-2-2(l) permits the Department to adjust only the allocation and apportionment of taxpayer's I.R.C. § 63 adjusted gross income and – except for the enumerated provisions contained within IC 6-3-1-3.5(b) – the Department is wholly without authority to disallow the royalty and interest deductions allowed under the federal tax scheme.

Taxpayer places too formalistic an interpretation on the authority granted the Department under IC 6-3-2-2(l). The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the* *taxpayer's business activity* . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (*Emphasis added*).

The audit was without authority to contravene the royalty and interest expense deductions legitimately claimed on the taxpayer's federal return. However, if the auditor believed that the effect of those deductions was to misallocate the taxpayer's Indiana income, IC 6-3-2-2(l) plainly granted the Department the authority to ignore the effect of the federal deductions and allocate that income to Indiana.

The audit determined that both the initial transfer of taxpayer's intellectual property to the Delaware holding company, and the consequent payment of royalty fees and interest back to the Delaware holding company, was without economic substance for the following reasons:

> 1. Other than the transfer of 100 percent of the Delaware holding company's stock, the Delaware holding company provided no other consideration for the receipt of the trade names and related good will;
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> 2. After the Delaware holding company received the royalty payments, it loaned those proceeds back to taxpayer – together with other members of the affiliated group – and charged interest at the market rate;
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> 3. All of the income received by the Delaware holding company was derived from the interest payments paid by taxpayer and the other members of the affiliated group.
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> 4. The royalty and interest income received by the Delaware company was not subject to that state's income tax (*See* Del. Code Ann. tit. 30 § 1902(b)(8)) or any other state's income tax.
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> 5. The Delaware holding company incurred none of the of the costs and performed none of the activities that created, enhanced, or protected the value of the trade names prior to the time the intellectual property was assigned to the Delaware holding company.
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> 6. The only time that the Delaware holding company charged royalty fees to taxpayer and the other members of the affiliated group, was when a state tax benefit could be obtained.
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> 7. The profitability of taxpayer and other members of the affiliated group was significantly decreased by the transfer of the intellectual property thereby invalidating the taxpayer's assertion that the transfer was made for legitimate purposes.

The audit was plainly justified in determining that taxpayer's royalty and interest federal deductions artificially distorted taxpayer's Indiana income and in disallowing those expenses in order to "more fairly represent" the amount of taxpayer's income apportioned to Indiana and to effectuate a more equitable apportionment of the taxpayer's Indiana income.

In addition, the audit would have been justified in disallowing the royalty and interest deductions on the ground that the expenses were incurred as a result of a "sham transaction."

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to <u>Gregory v. Helvering</u> 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied,* 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, *ex ante,* for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1337.

Taxpayer maintains that the transfer of its intellectual property to the Delaware holding company was made for a legitimate business purpose. Taxpayer argues that the royalty and interest payments were made in furtherance of that business purpose, that the payments were made at arms length, and that the value of the intellectual property – and the consequent payments to the Delaware holding company – were determined by an independent third-party.

There is no evidence that taxpayer's business operations changed after the intellectual property was transferred to the Delaware holding company. There is no evidence that the Delaware holding company performed any of the work necessary to preserve or enhance the value of the intellectual property. There is no evidence that the Delaware holding company incurred any independent expenses to manage, preserve, or enhance the value of the intellectual property. There is no evidence that the Delaware holding company ever exercised any independent authority over "its" intellectual property or that it ever had the actual authority to do so. There is no evidence that the Delaware holding company exercised any independent business judgment in an effort to more fully exploit the value of the intellectual property. There is no evidence that the various transactions entered into between taxpayer and the Delaware holding company in any way added to the value of the intellectual property.

The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Commissioner of Internal Revenue, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. IC 6-8.1-5-1(b).

The taxpayer has failed to meet its burden of demonstrating that the transfer of the intellectual property to the Delaware holding company or that the royalty and interest payments subsequently made were supported by any business purpose other than tax avoidance. Taxpayer's tender of royalty and interest payments was entirely illusory; the royalty payments were returned to the taxpayer in form of loans. Any value the Delaware holding company received from the interest payments accrued entirely to the benefit of taxpayer and the members of the affiliated because the Delaware holding company was entirely owned by taxpayer and its affiliates.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer maintains that its tax deficiency was not due to negligence and that it exercised reasonable care in respect to the duties placed upon it by the Indiana code and Department regulations.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

Despite the corrections made at the time of the original audit and the issues raised within taxpayer's protest, under the facts and circumstances as indicated in the record, taxpayer has demonstrated that it "exercised ordinary business care" and is therefore entitled to abatement of the ten-percent negligence penalty.

FINDING

Taxpayer's protest is sustained.

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